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10 April 1987

Assessing Japan's "Comprehensive Economic Package" 25X1

Summary

The recommendations laid out by the ruling Liberal Democratic Party (LDP) on 7 April provide few clues about how much stimulus Tokyo plans to undertake in coming months. Party leaders have said the package is worth $33 billion, but we would not equate that figure with government outlays. Actual government spending will not be clear until Tokyo produces a supplemental budget, probably in late summer or early fall. We believe it will be heavily influenced by Japanese economic prospects, which in turn will depend on the exchange rate, and by the political pressures created by international--in particular US--reaction to the Japanese trade surplus. 25X1

This memorandum was prepared by Japan Branch, Office of East Asian Analysis. Information available as of 10 April 1987 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Japan Branch, Northeast Asia Division, OEA, 25X1

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Waffling on the Stimulus Question

The LDP's recommendations, which will probably form the basis for a "comprehensive economic package" that former Foreign Minister Abe will outline on the 19th when he visits Washington, sidestep the question of whether Tokyo will increase its budget deficit in order to stimulate growth. The party's official statement sets out two seemingly contradictory goals--eliminating the issuance of deficit-financing bonds by 1990 and expanding domestic demand. To accomplish the latter, it recommends:

- Contracting an overwhelming majority of the public works spending included in the 1987 budget in the first half of the fiscal year, which began 1 April.

- Compiling a "drastic large-scale supplemental budget." 25X1

We agree with Embassy Tokyo's assessment of the LDP's proposal as "lacking in specificity" and believe that the ruling party has several reasons for being vague in public on fiscal policy. Most obviously, an admission that stimulus was required while the JFY 1987 budget is still before the Lower House--where it is likely to remain until late April--would give opposition parties an opportunity to demand amendment of an annual budget for the first time since 1972. Ruling party elders undoubtedly also recognize that all but one of the opposition parties would try to use this opportunity to make political hay, for example, by trying to force defense spending below the 1-percent of GNP limit, which the pending budget proposes to breach for the first time in several decades. 25X1

Based on analysis of Japan's last comprehensive economic package, we do not believe the $33 billion monetary value attached to the proposal should be taken at face value (see appendix). In the past, Tokyo has tended to overstate the stimulative effect of planned fiscal policy moves in order to satisfy key trading partners who believe expansive fiscal policies would help narrow the Japanese trade surplus. To boost the "value" ascribed by the government to its packages, Tokyo often includes the estimated impact of supply-side stimulus measures--such as loans for housing--that actually require private sector actions to boost growth. 25X1

The supplemental budget--and thus any additional government spending--also is only a small part of the overall package. New public works spending and subsidies in last fall's supplemental, for example, accounted for less than 10 percent of the total 1986 stimulus package. In any case, the economic impact of the supplemental budget will depend on how it is financed; previous budgets have involved a reallocation of existing funds, producing minimal economic impact. Not until the supplemental budget is announced late this summer or in early fall will it be clear how much of the package will be funded with new money. 25X1

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The Yen/Dollar Rate: A Key Determinant

We believe economic conditions at the time the supplemental budget is unveiled will be the key determinant of the degree of stimulus adopted. Even at the current exchange rate, Bank of Japan officials are worried that the country is headed for a recession. Simulations done on our model of the Japanese economy suggest the BOJ may technically be right--at a yen/dollar exchange rate of 140, Japan will probably record zero growth for at least two quarters in 1987. But our model forecasts real GNP growth of around 2 percent for the entire year, which would probably be high enough for opponents of an expansive fiscal policy to argue against any stimulus. If the yen has appreciated beyond 140 when work on the supplemental budget begins in earnest, however, Tokyo could well opt for a net increase in government spending instead of relying on supply-side stimulus measures than it has in the past. 25X1

A modest supplemental budget for FY 1987 would not preclude Tokyo from adopting a FY 1988 budget that supports growth. Japan's questionable economic outlook, the likelihood that Nakasone will be replaced as Prime Minister by someone who is more amenable to fiscal stimulus, and the prospects for continuing trade friction with the United States argue for a shift to a more expansive policy. Under certain circumstances, the Finance Ministry may be more "flexible" on fiscal policy as well. For example, if tax reform legislation involving introduction of a value-added tax passes, the Ministry might be willing to shift gears when it begins to review ministerial budget requests this fall. Even so, we would first need to see ferment in other quarters, including signs that the necessary talks to prepare for a policy charges were underway among businessmen, bureaucrats, and politicians. 25X1

Even if the 1988 budget were to support more growth than those in recent years, stimulus measures are likely to be carefully crafted with an eye to enabling decisionmakers to return to a policy of austerity as easily as possible. For example, we would expect stimulus to be financed by issuance of construction bonds and the sale of NTT shares. Both would limit the amount and duration of the pumpriming move. Moreover, such a financing mix would permit Tokyo to stick with its goal of eliminating "deficit-financing" bonds by 1990, because the government distinguishes between these bonds and construction bonds, which finance public works spending. Unless the goal of eliminating deficit-financing bonds is dropped, across-the-board increases in government spending are virtually impossible. 25X1

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Appendix

The Fall 1986 Comprehensive Economic Package

The comprehensive economic package announced by Tokyo last September bears a close resemblance to the recently unveiled LDP package. Among the measures included in the 1986 package were:

- Expanded public works spending
- Promotion of housing investment and construction of public facilities.
- Loan programs to aid small business
- Measures to encourage pass through of exchange rate gains and lower oil prices to consumers. [redacted] 25X1

The $24 billion (3.6 trillion yen) price tag placed on the package when it was announced was misleading, in our view. The plank on construction of public facilities, for example, referred to government encouragement of capital investment by private firms, most notably electric power companies and Japan's international telecommunications monopoly. Nevertheless, the planned expenditures of the utilities were included in the package's price tag, which many analysts mistakenly equated with government spending. In the case of loan programs for housing or small business, the loan principal was included in the total, even though the central government had to foot the bill only for the interest rate subsidy. [redacted] 25X1

It was not until the supplementary budget was announced a month later that the limited scope of the additions to the central government budget became clear:

- Only $900 million was budgeted for new public works. The other $2.8 billion in expanded public works spending involved loans from official financial institutions.
- Subsidies for small business and private sector initiatives totalled $190 million.
- Housing and urban development subsidies amounted to $1.2 billion. [redacted] 25X1

At the same time, however, spending by nonconstruction ministries was cut by $2 billion. Moreover, transfers to local governments and the National Debt Repayment Fund were sliced, leading to an overall reduction in government spending of $1.7 billion. [redacted] 25X1

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